UNITED PRESS INTERNATIONAL

Financial statements score low

June 19, 2004
By Dar Haddix

An estimated one-third of major publicly-traded companies file financial statements that do not really reflect their true financial state, a report by New York-based RateFinancials Inc. said.

"Despite the provisions of Sarbanes-Oxley, investors cannot accurately evaluate the securities of a significant portion of companies in the S&P based on their reported financial statements," said Victor Germack, founder and president of RateFinancials. "It's abundantly clear that companies continue to concoct creative – and not so creative – measures to make it difficult, if not impossible, to get a clear sense of their financial condition."

The observation that one-third of the companies obscure their financial state is based on one of the report's subcategories, "Areas of Financial Concern & Quality of Earnings," where 38 of 120 companies studied received a score of "Below Average" or "Poor." The 120 companies represent 40 percent of the market capitalization of the S&P 500 index.

In evaluating the companies, RateFinancials took into account factors in a number of categories such as quality of earnings, overall accounting policies, corporate governance, and the clarity and completeness of statement footnotes and the management's discussion and analysis. It ranked companies on both a numerical scale of one to 40 and also on a scale of one to five stars.

RateFinancials ranked 47 percent of the financial statements it analyzed as being, overall, average or "acceptable," 14 percent as "below average," and 1 percent as "poor." Thirty-five percent of the companies' filings received a "superior" rating, and 3 percent were ranked "outstanding"

"We can predict with a high degree of certainty that the ominous trend of earnings surprises and restatements will continue for the foreseeable future," Germack said.

Some companies with statements ranked "below average" were Archer Daniels Midland, Halliburton, Best Buy, Bristol Myers Squibb, Corning, Eastman Kodak, EDS, Gap, Janus Capital, Motorola, and Walt Disney.

Companies that earned an "average" rating include Lowe's, Boeing, Polo Ralph Lauren, DuPont, Intel, EMC, Medtronic, Merrill Lynch and Alcoa.

The filings of Microsoft, BMC Software, and Family Dollar Stores were among those rated "outstanding."

However, none of the companies surveyed achieved a perfect score of 40 points. RateFinancials' research also uncovered trends they called "alarming." Seventy-five percent of companies surveyed engaged in off-balance sheet financing, where they used complicated financial calculations to move long-term financial obligations off their balance sheets, affecting their debt-to-equity ratio. It was this type of mechanism, wrongly used, that figured prominently in the demise of Enron.

When calculating pension liabilities, 64 percent made unrealistic pension assumptions and forecasts, according to RateFinancials. They said that Generally Accepted Accounting Principles (GAAP) allows companies' reporting of pension financing to appear positive even though they are running large, long-term funding deficits in their pension plans.

And, the report said, 28 percent of companies examined used aggressive revenue recognition, where companies can often post revenue from transactions long before the goods and services or cash is received.

Germack said they didn't expect some companies to rate as low as they did.

“When we start to rate individual target companies, we have no preconceived notions as to what we will find,” Germack told United Press International. “Since our fundamental analysis involves an extensive examination of the various regulatory filings, we have to really dig, examine and compare the filings. Also we don't look at the stock prices or sell-side analysts' recommendations.” RateFinancials documents their analysis of each company's financial statements in a detailed report.

“However, we were surprised at the ratings and findings at 6 specific companies – believing them to be quality companies, well-run, open and transparent and having good governance.” Germack said, noting the only 2- out of 5-star rating achieved by General Mills, DuPont, Corning, Kodak, Yahoo and The Gap.

Manipulation of financial statements comes at a high price for some companies. Enron no longer exists. Italian firm Parmalat, now in bankruptcy, may not survive. But not all companies that restate earnings fall as far as these two. This past week aaiPharma (AAIIE), a Wilmington, N.C., drug firm, restated past earnings from 2002 and 2003 down from a profit of $1.18 per share to a loss of $1.17 per share. The firm itself may suffer delisting from the NASDAQ exchange, but investors have seen the stock price drop from above $30 per share to under $5 per share.

Germack observes that, whether the news is good or bad, companies do themselves and investors a favor by making their financial statements clear and easy to understand.